



## Q&amp;A

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## Geopolitical tail events cloud financial stability outlook

### What are the major financial stability risks in Europe?

The financial system in Europe is fragmented across jurisdictions. Thus, vulnerabilities and their magnitude differ among countries. Nevertheless, common shocks occur and they affect each Member State and the EU as a whole.

Currently, the good news is that the European financial system, and especially the banking system, is sound and resilient. Banks have solid capital and liquidity buffers allowing them to withstand even severe but plausible shocks.

For some time, the key systemic risks have originated from outside the financial system and are exogenous to the EU. A few years ago the pandemic was the main source of concern. Currently, I would point to geopolitical and cyber-related risks as the most important threats to the financial system. The likelihood of tail events is high now. The main challenge with this type of risks is how to measure their potential costs and calibrate the capital and liquidity buffers necessary to withstand their impact.

Geopolitical risk adversely affects real economies and financial systems globally: a trade war asymmetrically accelerates inflation and slows growth. This may trigger a repricing in global financial markets spilling over to liquidity risk, due to a high concentration of positions and high correlation of market valuations. The ensuing fire sales would raise the cost of funding of private and public sectors. Trade wars might also increase corporate credit risks. Geopolitical events also trigger operational risks: severe cyber incidents in EU banks have increased significantly in recent years, as well as hybrid threats to European critical infrastructure. The development of quantum computing could strengthen these risks even more.

While EU banks are generally resilient, EU non-banks, with their liquidity mismatches and significant exposures to non-EU markets, are more vulnerable to global market shocks. Their reaction could amplify adverse market dynamics with sizeable second-round effects for the broader financial system.

### To what extent has the development of NBFIs improved the financing of economies and led to the development of capital markets in Europe?

The importance of NBFIs in the global financial system has grown substantially over the last years. In 2023 alone all NBFIs subsectors grew at around twice the rate of their five-year average and more than double the pace of banking sector growth, raising their share in the total global financial assets to almost 50%. This may positively affect liquidity by lowering the risk premium. But their activity on its own is unlikely to substantially impact non-financial enterprises' propensity to seek market financing. The latter is largely the function of the size, level of development and sophistication of the corporate sector. Moreover, some NBFIs subsectors still remain heterogeneous across jurisdictions. For example, although the net assets of total European investment funds have almost doubled over the last ten years, the very same top five countries still account for more than 75% of the sector's assets. Also, the average fund size (by assets) in Europe is still small, which reduces economies of scale and leads to higher costs for investors.

The impact of the NBFIs sector on EU capital markets should be viewed through the country's financial wealth. More affluent societies are less risk-averse. In less wealthy countries households would prefer to accumulate savings as safe and liquid bank deposits rather than invest in capital markets without a guarantee of positive returns. This would confine the NBFIs space to thrive. In more risk-averse countries, such as Poland, bond funds comprise the vast majority of investment funds' assets. Therefore, their growth is transposed into the increased demand for debt instruments – domestic government bonds in particular. As sovereign debt is an important part of insurance companies' assets, the growing importance of this subsector would translate into its greater role as a provider of sovereigns' financing.

Looking ahead, a country's pension system might have a significant impact on the growth of capital markets. Relying

on a pay-as-you-go scheme, prevailing in the EU, may be insufficient to safeguard our pensioners' future. Therefore, European and national regulators should encourage the development of private pension systems. Scaling up our pensions markets will boost the flow of retail savings to the capital market, supporting economic growth.

### What are the stakes, and the challenges involved in the implementation of a macro-prudential approach to the regulation of the NBFi sector at the European and international levels?

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The Savings and Investments Union aims to develop the capital market, especially venture capital and private equity. It encourages institutional investors to engage more on this market. It is a very desirable direction. However the interest of retail, nonprofessional investors should be duly taken into account. There is an ongoing discussion about macroprudential measures for NBFIs, offering a good opportunity to highlight the need for solutions to ensure that the potential cost of higher exposition of NBFIs to risky assets is proportionally shared between customers and financial institutions. The regulations should primarily encourage professional investors to invest in venture capital at their own risk, as they are better prepared to manage related risk. Currently, despite the absence of any legal barriers, these investors are not keen to engage in risky assets. Thus, changes to the macroprudential measures should not lead to risk-averse investors – retail clients – being highly exposed to such investments.

Additionally, we observe that different financial institutions, like banks and insurance companies or investment funds, offer similar financial products, e.g. mortgage lending by insurance companies in many European countries. Thus, the macroprudential policy should combine an entity-based approach to regulations with activity-based ones, addressing certain types of activities. Such an approach should be, and for some time already has been, pursued in EU legislation. For example, EMIR regulates trading in OTC derivatives, irrespective of the legal form of entities engaged in such transactions, and the Securities Financing Transactions Regulation covers transactions such as repo or SBB. Covering the same activities with the same regulatory requirements, regardless of the institution conducting the business, should help to limit regulatory arbitrage and minimize the transfer of risk to less regulated parts of the financial system.

### What specific governance arrangements need to be put in place to achieve an efficient macroprudential approach in Europe? What are the priorities for strengthening cooperation between “macroprudential authorities” and European and national supervisors?

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The key responsibility for macroprudential policy in Europe lies with national authorities, which have the best knowledge of domestic markets and risks. Nevertheless, the European coordination of macroprudential policy is necessary to ensure a level playing field and the effectiveness of measures. To this end, the coordination and leading role of the European Systemic Risk Board can't be underestimated. It covers all sectors of the financial system in all Member States. Such an institutional arrangement helps to ensure an efficient, consistent and holistic approach to macroprudential policy in Europe. The strength of the ESRB builds on its members: representatives of all national and European authorities responsible for financial stability.

The ESRB has proven to significantly contribute to the resilience of the EU financial system, despite only having soft powers such as warnings and recommendations. From Poland's perspective, the ESRB recommendation on lending in foreign currencies supported our regulators in banning foreign currency lending to households. The ESRB also has a proven ability to flexibly and swiftly react to shocks in the EU financial system, while maintaining the (often delicate) balance of interests of host and home countries, with due consideration to the policies of non-eurozone countries. To this end, I think that the governance arrangements for macroprudential policy in Europe are appropriate. I would rather advise further strengthening of the ESRB, as indicated in the report “Building on a Decade of Success” published last year. The effectiveness of the ESRB could be improved by developing system-wide stress tests, putting more focus on new emerging risks and the growing role of the NBFIs in the EU financial system, as well as by enhancing the sharing of data among relevant national and European authorities.